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In The

SUPREME COURT OF THE UNITED STATES

October Term 1975

No. 75-578

PAUL S. MOLONEY and
ROMAN GRUBER, Executor of
the Estate of Dora M. Moloney,

Petitioners,

v.

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR WRIT OF CERTIORARI
To the United States Court of Appeals for the 6th Circuit

JOHN KENNEDY LYNCH
215 Williamson Building
Cleveland, Ohio 44114
216-771-2543
Attorney for Petitioners

COURT INDEX PRESS, INC. — 207 Walnut Street, Cincinnati, Ohio 45202 — (513) 241-3456

INDEX

Page

QUESTION PRESENTED 1

STATEMENT OF FACTS 2

REASONS FOR GRANTING WRIT 4

APPENDIX

Internal Revenue Code 1939, Sec. 3631 .....1a

Opinion of United States District Court for the Northern District of Ohio 2a

Opinion of United States Court of Appeals for the Sixth Circuit 11a

AUTHORITIES

Cases

Application of Leonardo, 208 F.Supp. 124 (N. D. Cal. 1962) 4

Executors of Estate of Barker v. Commissioner, 13 B.T.A. 562 (1928) 4

Field Enterprises, Inc. v. United States, 348 F2 485, 172 Ct. Cl. 77 (1965) 4

Philip Mangone Company v. United States, Ct. Cl. 54 F2 168 (1931) 4

Reineman v. United States, 301 F2 267 (7th Cir. 1962) 3-4

Statutes

Internal Revenue Code of 1939, Sec. 3631 2-3

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Petitioner prays that Writ of Certiorari issue to review the judgment of the United States Court of Appeals for the 6th Circuit entered on July 23, 1975; motion for re-hearing was denied on September 17, 1975. Jurisdiction of this Court is invoked under 28 USC 1254 (1).

QUESTION PRESENTED

DID THE TRIAL COURT ERR IN SETTING ASIDE DEFICIENCIES ASSESSED BY THE INTERNAL REVENUE SERVICE WHICH WERE BASED ON AN ILLEGAL SECOND EXAMINATION OF TAXPAYERS' RECORDS FOR 1952?

STATEMENT OF FACTS

The petitioners filed a tax refund suit against the Government in the amount of $50,771.75 for alleged overpayment of a deficiency assessed for the year 1952. Taxpayers appealed from a partial summary judgment entered in favor of the Government in the amount of $35,000.00 and the Government appealed from the judgment in favor of taxpayers for the balance.

The deficiency assessed was based on the Government's determination that a reduction in the stated capital of the Moloney Company, a corporation, from $50,000.00 to $5,000.00, was essentially equivalent to the distribution of a taxable dividend under Sec. 115 (g) of the Internal Revenue Code of 1939, and thus was taxable to the individual taxpayers as ordinary income to the extent of available earnings and profits of the corporation. The taxpayers were the sole owners of the stock of the corporation.

A partial summary judgment was entered in favor of the Government determining that the taxpayers' right to recover $35,000.00 of the claim for refund was barred under the provisions of Section 322 (b) of the Internal Revenue Code of 1939, because that amount was paid over two years before the claim for refund was filed. The remaining issues were tried on the merits before the District Judge sitting without a jury. In an opinion reported at 375 F.Supp. 737 (1974), the Court entered judgment awarding taxpayers a refund of the balance of the claim on two alternate theories. It first held that there had not, in fact, been any payment passing from the corporation to the taxpayers and that the redemption, if such it was, was essentially a paper transaction which left the taxpayers in no different position from what they had been before. Alternately, the trial judge held that the deficiency assessment was made following an improper audit of taxpayers' books in violation of Section 3631 of the Internal Revenue Code, which provides:

> "No taxpayer shall be subjected to unnecessary examinations, and only one inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise, or unless the Commissioner, after investigation, notifies the taxpayer in writing that an additional inspection is necessary."

Relying upon *Reineman* v. *United States,* 301 F2 267 (7th Cir. 1962), the trial judge held that the provision banning the examination, while containing no express sanctions for violation, implicitly bans any deficiency assessment which results from the audit.

The 6th Circuit Court of Appeals reversed the trial Court and remanded for entry of judgment in favor of the Government, holding that the trial Court's determination that no benefits passed to the taxpayers was clearly erroneous and that Sec. 3631 Internal Revenue Code of 1939 does not bar imposition of the deficiency, although it did agree that the second examination of taxpayers 1962 records was illegal as found by the trial Court.

Because of the above finding of the Appeals Court, it did not reach the question of whether partial summary judgment was properly entered in the Government's favor.

The trial Court relied on *Reineman* v. *United States,* 301 F2 267 (7th Cir. 1962) in holding that the illegal second examination barred the deficiency assessment. The Court of Appeals disagreed with the trial Court on the ground that in *Reineman* the second examination was without the consent of the taxpayer and that in the subject case the taxpayer did not object. However, the record discloses that the taxpayers were not aware that their 1952 records were being examined until after the investigation was completed.

REASONS FOR GRANTING WRIT

The question presented is of general public interest since it relates to the question of whether illegal activities by the Internal Revenue Service in conducting second examinations of taxpayers' records without notifying taxpayers, as required by statute, can be done without any remedy to the taxpayers.

There is, also, conflict in the Court decisions of the various Circuit Courts of Appeals, the Court of Claims and the Tax Court. *See Reineman* v. *United States,* 301 F2 267 (7th Cir. 1962); *Application of Leonardo,* 208 F. Supp. 124 (N. D. Cal. 1962), holding that the assessment is not valid where there is an illegal second inspection of the taxpayers' books; to the contrary, *Philip Mangone Company* v. *United States,* Ct. Cl. 54 F2 168 (1931); *Executors of Estate of Barker* v. *Commissioner,* 13 B.T.A. 562 (1928); and *Field Enterprises Inc.* v. *United States,* 348 F2 485, 172 Ct. Cl. 77 (1965).

In view of the important question here involved, that is: "May the Internal Revenue Service violate the law with impunity?", it is submitted that this Writ of Certiorari should be granted.

In conclusion, for the reasons stated, the petitioners respectfully pray that their Writ of Certiorari be granted.

Respectfully submitted,

JOHN KENNEDY LYNCH
Attorney for Petitioners

APPENDIX

STATUTE

Internal Revenue Code 1939, Sec. 3631

No taxpayer shall be subjected to unnecessary examinations, and only one inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise, or unless the Commissioner, after investigation, notifies the taxpayer in writing that an additional inspection is necessary.

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF OHIO
EASTERN DIVISION

PAUL S. MOLONEY, and DORA M. MOLONEY,
Plaintiffs,

vs.

UNITED STATES OF AMERICA,
Defendant.

No. C 67-725

OPINION

(Filed January 24, 1974)

YOUNG, J:

This is an action by the plaintiffs to recover income taxes which they claim were improperly assessed against them. At the time of trial, the action had been pending for about six years. The taxes involved are for the year 1952. At an earlier stage of the proceeding it was held that the greater part of the plaintiffs' claim was barred by the statute of limitations. The trial was thus concerned with a balance of $15,771.75 out of plaintiffs' original claim of $50,771.75.

Basically, the evidence reveals that the dispute arises out of the incorporation of part of the plaintiffs' business, which had been operated as a partnership. The plaintiffs had operated a very successful business of manufacturing and selling aluminum combination windows and doors, commencing in 1947. It became international in scope. The bank which was financing their operations, and the European organizations they were dealing with were unhappy about doing business with a partnership consisting of two individuals. In order to

satisfy them, a corporation was created in 1950. Aluminum restrictions imposed during the Korean war threatened to destroy the plaintiffs' business, so the corporation was not activated until 1951. As originally set up, the corporation was shown as having capital stock of $50,000, in the form of 100 shares of common stock divided equally between the plaintiffs. In 1952, it was determined that this had been a mistake, as the stated capital of the corporation was $500.00, and it had been intended actually to begin business with a capital of $5000.00. Entries were made in the corporate records and partnership records reflecting the redemption of ninety shares of stock, thus reducing the capital from $50,000.00 to $5000.00.

The corporation, when it was activated in 1951, did not take over the entire business of the partnership. It only took over the manufacturing operations, while the sales operations continued to be the business of the partnership. The manufacturing operations and inventory were taken over by the corporation, which paid for them by the issuance of the stock to the plaintiffs and by creating indebtedness to the partnership for the balance of the value transferred. No stock certificates were ever actually issued and delivered to the plaintiffs at any time.

It is clear beyond the slightest question that these were essentially paper transactions, which satisfied the bank and the European concerns, but left the plaintiffs financially and otherwise exactly where they had always been. It is equally clear that the "redemption" of the ninety shares, to reduce the corporate capital from $50,000.00 to the $5,000.00 it was supposed to have been to begin with, did not change the plaintiffs' financial situation in the slightest. They had no more money or property individually or as partners, and the corporation had no less money or property, after the "redemption" than before.

Sometime between 1953 and 1955 the tax returns of the plaintiffs and the corporation were audited by the Internal

Revenue Service. Agent Vale made the audit, and it was reviewed by Agent Drummond. Some changes were made, increasing the amount of taxes which the plaintiffs were assessed. No claim was made that the "redemption" of the stock was equivalent to a $45,000.00 taxable dividend to the plaintiffs.

Some years later, another agent of the Internal Revenue Service, a man named Suarez, came to examine the plaintiffs' tax returns for some later years, around 1957. Mr. Suarez was not qualified as an accountant. He was produced as a witness by the Government, but did not establish himself as being entitled to any credibility. He operated strictly upon his personal construction of the Government's manual, which he believed said that all transactions between closely held corporations and their stockholders resulted in taxable income to the latter. Although he denied examining any of the plaintiffs' personal records, or much of anything else, for that matter, except the corporation records, his denial is contradicted by other testimony, and by evidence that he devoted a great deal of time to his examination. Although he asked his superiors for authority to reopen the audit of the 1952 corporate returns, and was denied permission, he nevertheless determined that the "redemption" of the corporate stock resulted in taxable income of $45,000.00 to the plaintiffs in 1952, and assessed them additional taxes upon that amount of money.

Thereafter further proceedings were had, as a result of which the plaintiffs, over a period of time, paid these taxes and others, and then commenced this action to recover the amounts improperly assessed.

Three questions are discussed by the parties:

First, whether the "redemption" so-called of the shares of the corporation was essentially equivalent to a dividend distribution;

Second, whether there was an improper second examination of the taxpayers' books and records for 1952 which would invalidate the deficiencies for that year; and

Third, whether the taxpayers are estopped from maintaining this action.

I.

As to the first question the evidence leaves no doubt whatever that the transactions with relation to the stock of the incorporated part of the plaintiffs' operations resulted in neither gain nor loss to anybody, either the plaintiffs or the corporation.

The 1939 Internal Revenue Code Section 115, "Distributions by Corporations," sub-paragraph (a) states:

> "The term 'dividend' when used in this chapter . . . means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made . . . ."

Sub-paragraph (g) states:

> "Redemption of Stock. — If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend."

Treasury Regulations 111, promulgated under the Internal Revenue Code, states: (Sec. 29.115-9).

"Distribution in Redemption or Cancellation of Stock Taxable as a Dividend. — If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

"The question whether a distribution in connection with a cancellation or redemption of stock is essentially equivalent to the distribution of a taxable dividend depends upon the circumstances of each case. A cancellation or redemption by a corporation of a portion of its stock pro rata among all the shareholders will generally be considered as effecting a distribution essentially equivalent to a dividend distribution to the extent of the earnings and profits accumulated after February 28, 1913."

The circumstances of this case make it abundantly clear, except perhaps to Agent Suarez, that the transaction did not distribute any money whatever to the plaintiffs. The Government's arguments attempting to support the indefensible position of the untrustworthy Agent Suarez are ingenious, but not persuasive. A determination based upon the circumstances of a particular case is, of course, purely a question of the facts shown in evidence in the case. The facts here make it clear that except as paper-work, there was not even a distribution of anything, much less any sort of dividend or payment in cash or in kind, to the plaintiffs. Perhaps the plaintiffs' auditors and attorneys should have been more careful, or used other methods, in their attempts to keep the plaintiffs' bank and European suppliers happy, and thus avoided these years of time-consuming and expensive disputes and litigation. It is equally arguable that the Government should have been more careful

in selecting its employees, or less stubborn in defending its employee's lack of understanding.

In any event, it is clear that the plaintiffs are entitled to recover those portions of the taxes paid as a result of the improper finding that they received a dividend of $45,000.00 in 1952, to the extent that recovery is not barred by the statute of limitations.

II.

The resolution of the first question essentially renders moot the second question as to whether the deficiency was assessed as the result of an improper audit, and that such an improper audit would invalidate the deficiencies.

The Court has no doubt that whatever the Government now chooses to call the activities of Agent Suarez, or what Agent Suarez claims about his activities, his testimony was too evasive, and too much contradicted by other evidence and the facts of the case, to be accorded any probative force. What in fact he did was to make a new audit which reached a contrary conclusion to that reached by the Agent Vale which was approved by Agent Drummond. It is impossible to see how Agent Suraez could have concluded that the plaintiffs received an additional $45,000.00 of taxable income in 1952 unless he made an audit. He and the Government maintain, in spite of the overwhelming evidence to the contrary, that the plaintiffs did receive this income.

Section 3631 of the Internal Revenue Code provides that,

> "No taxpayer shall be subjected to unnecessary examinations, and only one inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the Commissioner, after investigation, notifies the taxpayer in writing that an additional inspection is necessary."

It is not pretended that the plaintiffs requested an additional inspection of their records for 1952, or that they received

any written notice from the Commissioner that an additional inspection was necessary.

The Government, adroitly attempting to carry water on both shoulders, says that since the plaintiffs let Agent Suarez examine their records for 1952, they waived any right to rely upon the provision against a second inspection. In order to waive a protection of the law, there must be a voluntary relinquishment of a known right. In other connections, the courts lay much emphasis on the word "voluntary," and hold that when a government official starts throwing his weight around, merely acceding to his demands is not sufficient to establish the element of voluntariness of the accession.

In spite of the protestations of the public relations men for the Internal Revenue Service that it is a kindly and benevolent organization which always leans over backward to make sure that it does not do anything but help the taxpayer be sure that he does not pay a penny more tax than the Government is justly entitled to, such press-agent piffle has little relation to the realities which are patent to those experienced in dealing with the rank and file of this great bureaucracy. When the agents come around, the taxpayer had better cooperate, or he will be made to rue the day. This case itself is an excellent example of this reality. Plaintiffs cannot be held to have waived their right to the protection of § 3631 of the Internal Revenue Code simply because they did not choose to go to the mat with Agent Suarez. His attitude on the witness stand reveals pretty clearly how futile that would have been.

The Government also argues that § 3631 does not contain any sanctions for such a violation as occurred here. The Court is not inclined to render the section nugatory because it does not state explicitly that no assessment of deficiency can be made on the basis of an inspection forbidden by the section. Such a result is implicit in the statute. Otherwise it would be completely meaningless. This same conclusion was reached by the Court of Appeals for the Seventh Circuit in *Reineman* v. *United States*, 301 F.2d 267 (1962). And see

also *Application of Leonardo*, 208 F. Supp. 124 (N.D.Cal. 1962).

If, therefore, it were necessary to determine the issue of a second audit, this Court would have no alternative but to find in favor of the plaintiffs as to this question.

III.

The final question is raised by the Government's claim that the plaintiffs are estopped from maintaining this action because the issue of the stock redemption was before the Appellate Division of the Internal Revenue Service along with a number of other deficiency claims for the years 1952, 1953, 1954 and 1955, and was included in an offer of settlement which was formally accepted.

The Government claims that as a result of this, only the reduced amounts of other claims were assessed and collected, and by lapse of time the Government has lost the opportunity to seek to collect the full amounts of these other claims. Thus, it is claimed that the Government has acted to its detriment on the plaintiffs' offer, which included assessing the full amount of the stock redemption issue.

Plaintiffs contend that there was not a compromise, but a settlement of a disputed tax. Such settlements are frequently made for various reasons, such as to avoid having interest accrue while the dispute is being litigated. The member of the Internal Revenue Service who handled the settlement testified that in most cases the settlement does not estop the taxpayer from filing a claim for a refund. He did not testify, nor offer any facts which would show, that the settlement was some sort of a compromise.

As a practical matter, the bar of the statute of limitations has effectively deprived the plaintiffs of about two-thirds of the amount which they sought to have refunded, so that there is no showing that the Government has actually suffered any detriment by giving up any claims which it may have

given up, since it has been able to retain part of the moneys to which plaintiffs are entitled.

The burden of establishing the defense of estoppel is upon the Government. It has failed to sustain it.

IV.

For all of the foregoing reasons, the Court concludes that the plaintiffs are entitled to recover in this action in the amount of $15,771.75, that portion of their claim for refund which is not barred by the statute of limitations, together with interest thereon from the date of the original payments to the Government.

This opinion will serve as the Court's findings of fact and conclusions of law. Plaintiffs shall prepare and submit an order expressive thereof in accordance with the Local Civil Rules.

/s/ DON J. YOUNG
United States District Judge

Toledo, Ohio

Nos. 74-1621 and 1763

IN THE UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

PAUL S. MOLONEY and ROMAN GRUBER, Executor of the Estate of Dora M. Moloney, *Plaintiff-Appellants,* v. UNITED STATES OF AMERICA, *Defendant-Appellee.*	AN APPEAL from the United States District Court for the Northern District of Ohio.

Decided and Filed July 23, 1975.

Before: PECK and ENGEL, Circuit Judges, and O'SULLIVAN, Senior Circuit Judge.

ENGEL, Circuit Judge. This tax refund suit in the district court arises from a deficiency assessed by the government against Paul S. Moloney and Dora M. Moloney[1] in the amount of $50,771.75 in unpaid income taxes for the year 1952. Taxpayers appeal from a partial summary judgment entered in favor of the government in the amount of $35,000.00, and the government appeals from the judgment in favor of taxpayers for the balance.

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[1] Dora Moloney died in 1973 and Roman Gruber was substituted for her as co-plaintiff in his capacity as executor of her estate.

The deficiency assessment was based upon the government's determination that a reduction in the stated capital of The Moloney Company, a corporation, from $50,000 to $5,000 pursuant to a stock redemption resolution, was essentially equivalent to the distribution of a taxable dividend within the meaning of Section 115(g) of the Internal Revenue Code of 1939, and hence was taxable to the individual taxpayers as ordinary income to the extent of available earnings and profits of the corporation. It is undisputed that, at the time, the taxpayers were the sole owners of the capital stock of the corporation.

A partial summary judgment was entered in favor of the government determining that the taxpayers' right to recover $35,000 of the claim for refund was barred under the provisions of Section 322(b) of the Internal Revenue Code of 1939, because that amount was paid over two years before the claim for refund was filed. The remaining issues were tried on the merits before the district judge sitting without a jury. In an opinion reported at 375 F. Supp. 737 (1974), the court entered judgment awarding taxpayers a refund of the balance of the claim. The trial court ruled in favor of taxpayers on two alternate theories. He first held that there had not, in fact, been any payment passing from the corporation to the taxpayers and that the redemption, if such it was, was essentially a paper transaction which left the taxpayers in no different possition from what they had been before. Alternately the trial judge held that the deficiency assessment was made following an improper audit of taxpayers' books in violation of Section 3631 of the Internal Revenue Code, which provides:

> "No taxpayer shall be subjected to unnecessary examinations, and only one inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise, or unless the Commissioner, after investigation, notifies the taxpayer in writing that an additional inspection is necessary."

Relying upon *Reineman* v. *United States,* 301 F. 2d 267 (7th Cir. 1962), the trial judge held that the provision banning the examination, while containing no express sanctions for violation, implicitly bans any deficiency assessment which results from the audit.

We reverse and remand for entry of judgment in favor of the government, holding that the trial court's determination that no benefit passed to the taxpayers is clearly erroneous and that under the circumstances here, Section 3631, Internal Revenue Code of 1939, does not bar imposition of the deficiency. We thus do not reach the question of whether partial summary judgment was properly entered in the government's favor.

The general circumstances of the transaction in question are fairly and accurately reported in the district court opinion as follows:

> Basically, the evidence reveals that the dispute arises out of the incorporation of part of the plaintiffs' business, which had been operated as a partnership. The plaintiffs had operated a very successful business of manufacturing and selling aluminum combination windows and doors, commencing in 1947. It became international in scope. The bank which was financing their operations, and the European organizations they were dealing with were unhappy about doing business with a partnership consisting of two individuals. In order to satisfy them, a corporation was created in 1950. Aluminum restrictions imposed during the Korean war threatened to destroy the plaintiffs' business, so the corporation was not activated until 1951. As originally set up, the corporation was shown as having capital stock of $50,000, in the form of 100 shares of common stock divided equally between the plaintiffs. In 1952, it was determined that this had been a mistake, as the stated capital of the corporation was $500.00, and it had been intended actually to begin business with a capital of $5000.00. Entries were made in the corporate records and partnership records reflect-

> ing the redemption of ninety shares of stock, thus reducing the capital from $50,000.00 to $5000.00.
>
> 375 F. Supp. at 738

While the foregoing facts are fully supported by the record, we find the facts in the paragraph which follows to be clearly erroneous, (F.R.Civ. P. 52):

> It is clear beyond the slightest question that these were essentially paper transactions, which satisfied the bank and the European concerns, but left the plaintiffs financially and otherwise exactly where they had always been. It is equally clear that the "redemption" of the ninety shares, to reduce the corporate capital from $50,000.00 to the $5,000.00 it was supposed to have been to begin with, did not change the plaintiffs' financial situation in the slightest. They had no more money or property individually or as partners, and the corporation had no less money or property, after the "redemption" than before. 375 F. Supp. 738

As the trial judge found, the corporation was set up with its contribution of capital stock shown to be in the amount of $50,000. While by the time of trial many of the records actually involved were no longer available,[2] it is undisputed that the opening balance sheet of the corporation showed stock capital of $50,000.[3] Also undisputed is that a resolution dated January 15, 1952 was recorded in the minute book of

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[2] Paul Moloney testified that the records were transferred with the sale of the business, and were not returned.

[3] According to the corporate records and the corporate income tax return, the opening balance sheet was as follows:

ASSETS

Inventories:		
Raw materials	$200,739.93	
Work in process	863.40	
Supplies	1,446.24	$203,047.57

the Corporation providing for the redemption of 90 shares of common stock "at the original issue price of Five Hundred Dollars ($500.00) per share".[4] The closing balance sheet for

Capital Assets:		
Machinery or equipment	$ 18,151.32	
Trucks	7,538.03	
Patterns and dies	3,607.71	
Office furniture and fixtures	2,468.30	
Small tools	500.00	
	$ 32,265.36	
Less Reserve for Depreciation	3,639.51	$ 28,625.85
Unexpired Insurance	$ 2,998.97	
Utility Deposit	100.00	$ 3,098.97
Total Assets		$234,772.39
LIABILITIES		
Current Liabilities:		
Accounts Payable — Paul S. and Dora M. Moloney, d/b/a The Moloney Company		$184,772.39
CAPITAL		
Capital Stock — common without par value		
Authorized 250		
Issued 100		
Stated value		$ 50,000.00
Total Liabilities and Capital		$234,772.39

[4] The resolution adopted provided:

"WHEREAS, The Moloney Company has a substantial surplus of assets over liabilities and capital, and

WHEREAS, the present and anticipated future operation of the corporation does not require a maintenance of the substantial capitalization presently existing,

BE IT, THEREFORE, RESOLVED that The Moloney Company purchase and retire proratably from present shareholders ninety (90) shares of its issued and outstanding no par common stock at the original issue price of Five Hundred Dollars ($500.00) per share, and that the Directors be instructed to negotiate, arrange and carry out such purchase."

the year 1952[5] showed capital stock of $5,000.00. The record fails to reveal any amendments to the balance sheets or to the resolution.

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[5] According to the corporate income tax return, the closing balance sheet for the year 1952 was as follows:

ASSETS

Cash		$ 5,951.77
Notes and accounts receivable	$136,199.80	
Less: Reserve for bad debts	-0-	136,199.80
Inventories:		
Raw materials	58,421.75	
Work in process	426.50	
Finished goods	3,231.00	
Supplies	1,463.70	63,542.95
Capital Assets:		
Depreciable assets:		
Small tools	500.00	
Per schedule for Schedule I	46,903.35	
Total depreciable assets	47,403.35	
Less: Reserve for depreciation	9,316.03	38,087.32
Other assets (itemize)		
Prepaid and deferred expenses	85.77	
Unexpired insurance	5,504.09	
Utility deposit	100.00	
Leasehold improvements, net	6,475.98	12,165.84
Total Assets		$255,947.68

LIABILITIES

Current Liabilities:		
Accrued expenses:		
Rent	3,500.00	
Salaries and wages	4,691.85	
Hospitalization	97.31	
Property taxes	1,007.75	
Payroll taxes & insurance	1,673.28	
Federal taxes on income	130,000.00	$140,970.19

From the balance sheets, it can thus be seen that the corporation's stock capital was reduced from $50,000 to $5,000 during the taxable year. If there was in fact no redemption of $45,000 in capital stock, where did that money go?

It was claimed on behalf of the taxpayers that the $45,000 in effect never existed in the first place, and that when the corporation was activated, the taxpayers' accountants and attorneys mistakenly and without authority set the capital stock account up at $50,000 instead of an intended $5,000. Thus, it is claimed, while the correction was treated in form as a redemption, it was in fact no more than the correction of a clerical error which should never have occurred in the first place. Any proof of such an assertion must rest solely upon the parol testimony of a subjective intent on the part of the taxpayers which is claimed to have existed at the time the corporation was activated, for no such intention whatever appears in any of the books and records of the corporation, or in any of its tax returns.

We are, of course, bound to view the evidence in the light most favorable to the taxpayers here. Even on such basis, however, their case cannot be made out. As did the trial judge, we credit the testimony of Paul Moloney. However, at best his testimony only shows a complete and admitted lack of understanding of the issues in the case and of the claim of mistake which was advanced on his behalf to support the refund. Moloney's concept of what happened is ambiguous. He appears first to believe that the $50,000 reported as the value of a capital stock in the opening balance sheet

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CAPITAL

Capital stock — common without par value		
Authorized 250		
Stated value	5,000.00	
Earned surplus and undivided profits	109,977.49	114,977.49
Total Liabilities and Capital		$255,947.68

reflected a cash contribution which he never in fact made.[6] As the opening balance sheet itself shows, however, the corporation started business with no cash at all. The entire assets of $243,772.39 were in the form of inventories, capital assets such as machinery, trucks and the like, and values attributable to unexpired insurance and utility deposits. At no time has it ever been claimed that the assets as reported in the balance sheet were either improperly or inaccurately listed, or that the book values attributed to them were not correct.

Alternately Paul Moloney appears to have believed that the $50,000 reported as the value of common stock was actually, though mistakenly, paid in cash by him and subsequently, through adjustment of accounts, was merely returned because

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[6] Q So you organized the corporation in 1950. Do you recall what the capital investment was on the part of your wife and yourself?

A In the corporation?

Q Yes.

A Well, we were capitalized for $500 in the corporation, and subsequently there was $50,000 put into the corporation. And I think that — while I don't believe there was any stock issued, I believe we got a hundred shares of stock.

Q Now, was that $50,000 actually paid in for the stock?

A Not a penny.

Q Now, I will draw your attention to the 1952 fiscal year corporation return. Do you recall the balance sheet on that return? I will point out to you line 14-B.

Do you recall why that $50,000 stock, common stock, figure at the beginning of the fiscal year was changed to 5,000 at the end of the fiscal year?

A My recollection is it was never intended to be 50,000 in the first place. It was intended to be 5,000.

Now, I am not sure, we are going back 24, 25 years, but perhaps I as a salesman and going over to Germany — which I did do. I went over there, I bought $750,000 worth of merchandise from the Germans over there. Perhaps in my salesmanship, in my dealings, that I got $50,000 mixed up some way, you know, instead of five. But I do know that we didn't have — we didn't have $50,000.

that payment was in error.[7] Moloney neither made a cash contribution mistakenly or otherwise, nor was such a contribution in cash ever reflected on the books of the corporation. He did, however, get $45,000 back, albeit not in cash.

The answer to how the $45,000 got out of the corporation and back into the personal assets of the individual taxpayers lies in the testimony of Moloney's own witnesses and in understanding the profitable operations of The Moloney Corporation which occurred during its first year of business. As reported on the corporation income tax return, The Moloney Corporation, during its first full year of business reported a net income before taxes of $242,656.62. The corporation reported an earned surplus and undivided profits at the close of the taxable year in the amount of $109,977.49.

A reduction on the balance sheets of the capital stock of a corporation cannot take place without corresponding adjustments being made elsewhere. So much was admitted by Harry R. Valley, C.P.A., who was the accountant for Moloney during this period and who testified on his behalf at the trial. Obviously that adjustment had to have been made between January 15, 1952, the date of the resolution, and January

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[7] Q Do you remember any Board of Directors meetings with respect to setting up the corporation where the stated capital was discussed?

A No, I don't. See, the Board of Directors, I believe, would have consisted of my wife, myself, Rusk Haverfield, and Harry Valley.

Q Was there an agreement between the partnership and the corporation with respect to the transfer of assets, a written agreement?

A A written agreement, no.

Q Now, outside of the testimony that you heard today from Mr. Valley, did you know personally what was the adjustment to reduce the capital account?

A At the time the adjustment was made?

Q Yes. Did you know what accounts, what offsetting adjustments were made?

A Well, yes, I knew what offsetting adjustments. When I found out that we had taken money from the partnership into the corporation, which was never intended to be taken, it was a question of reversing. Certainly I knew that, that it was being reversed.

31, 1952, the close of the corporation's taxable year when the change appeared. Upon the undisputed proofs, that adjustment was accomplished by a reduction in an "Inter-Company Account" which existed between The Moloney Corporation and the Moloney partnership, and, on the balance sheet, by a comparable reduction in the reported accounts receivable.

As correctly found by the trial judge, the sales operations of The Moloney Corporation continued to be operated as a partnership after all of the manufacturing operations were transferred to the corporation. Thus, as reported by Paul Moloney:

> "The partnership bought this merchandise from the manufacturing company at X dollars and resold it for X dollars and the partnership existed upon the difference between the X dollars." Supp. App. 33

These continuing transactions were shown in the "Inter-Company Account" which reflected from time to time the amounts which Paul and Dora Moloney, as partners in the sales partnership, owed to the corporation for purchases of its merchandise.

The reduction upon the books of the corporation in the stated value of capital stock contribution was accomplished by crediting to the account of the partnership the sum of $45,000, which it owed for merchandise purchased, thus relieving it and its only partners, the taxpayers, of a legal obligation to repay the corporation that amount. This is acknowledged by Moloney's accountant, Valley,[8] and Moloney himself appears

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[8] Now, when reversing the alleged error one would debit the capital account by 45,000, isn't that correct?

A That's right.

Q And they would credit the inter company account?

A That's right.

Q And in crediting the inter company account what would they actually do? What does that mean when we credit an accounts receivable?

at least to have had some vague understanding of the nature of the transaction.

In our judgment, the foregoing undisputed evidence establishes as a mater of law that there was a distribution in the amount of $45,000 to the taxpayers. We further conclude that such a redemption was essentially equivalent to a taxable dividend within the meaning of Section 115(g) of the 1939 Code. *Bradbury* v. *C.I.R.*, 298 F. 2d 111 (1st Cir. 1961); *United States* v. *Davis*, 397 U.S. 301 (1970). The taxpayers were the only shareholders in the corporation. They were also sole members of the partnership. Thus, they were in total control of both. The redemption was not only pro rata between them, but was in an amount less than the available earnings and profits of the corporation for that year.

The evidence here shows that the corporation cancelled $45,000 of the debt owed to it by the partnership in consideration for the retirement of 90 shares of stock. The benefit the partnership received from the cancellation of the debt was a direct benefit to the taxpayers in their individual capacities. Cancellation of a valid debt is, of course, valuable consideration and can result in tax consequences as do many non-cash transactions. See *Bradbury* v. *C.I.R.*, *supra*.

It is provided in the Treasury Regulations to the 1939 Code:

> "A cancellation or redemption by a corporation of a portion of stock pro rata among all the shareholders will generally be considered as affecting a distribution essentially equivalent to a dividend distribution to the extent of earnings and profits accumulated after February 13, 1913." Section 39.115(g)-1.(2)

A In this particular case, just looking at the balance sheet that is lying before me, the chances are that the account receivable from the — well, the account receivable from the partnership would have been reduced.

Q And that means that the partnership would owe less money to the corporation?

A That's right.

Supp. App. pp. 187-188

Thus, there is created a presumption of dividend equivalence where it is shown, as here, that value had been transferred from the corporation to the individual taxpayers and where there were ample earnings and profits accummulated from which such benefit could be paid. The regulation further provides that:

> "The question whether a distribution in connection with a cancellation or redemption of stock is essentially equivalent to the distribution of a taxable dividend depends upon the circumstances of each case."
>
> Section 39.115(g)-1.(2)

In evaluating the circumstances of each case to determine whether dividend equivalence exists, courts have looked to "the net effect of the distribution rather than the motives and plans of the taxpayer or his corporation". *Smith* v. *United States,* 121 F. 2d 692, 696 (3rd Cir. 1941). See also *Keefe* v. *Cote,* 213 F. 2d 651 (1st Cir. 1954). While the motives of the taxpayer may not always be irrelevant in determining "net effect", Cf. *Bradbury* v. *C.I.R., supra,* they do not control. Where the net effect of the distribution is, as here, to move the equivalent of cash and undivided surplus profits out of the corporation to the taxpayers, who continue as sole owners of the corporation, we believe it is immaterial that it may have been prompted by a subjective motive to correct a claimed error in the amount of stated capital which was originally intended to be contributed. This is particularly so where such a motive is not expressed upon the corporation books and where, in fact, it appears that if such was initially an error, it was knowingly suffered to exist throughout the entire taxable year after discovery, because its effect was considered beneficial to the interests of the corporation. In this respect, Harry R. Valley testified:

> "I know that we explained – or I am quite sure I explained that one of the basic reasons for leaving this

> initial opening balance sheet stand the way it was instead of attempting to correct it had been that a number of financial statements had been issued to banks and to creditors and if we had gone back, if the accountants had gone back and insisted that the client correct his records on a retroactive basis, we would have put him into an embarrassing situation with his creditors because there were financial statements out that indicated this earlier value." Supp. App. 168-169

In *Bradbury* v. *C.I.R., supra,* it was shown that the taxpayer, as the sole owner of Bradbury Corporation, had been in the practice periodically of drawing from company funds for her personal expenses. Debits to her account were made after each withdrawal to the point where finally that account showed a debt to the corporation of over $20,000. To cancel the debt, the taxpayer thereupon transferred 44 shares of her stock back to the corporation and her account was credited in the amount of $22,489.28. The First Circuit, noting that there may have been a business purpose for the transfer, nevertheless decided this motive did not defeat a finding of dividend equivalence:

> "It is obvious that where – subsequent to a distribution of property – there has been no real shift in intercorporate interest or no significant change in the economic interest of the parties involved, a proclivity towards dividend equivalence usually results."
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> *Bradbury* v. *C.I.R., supra,* at 116, quoting Cohen, Surrey, Tarleau and Warren, A Technical Revision of the Federal Income Tax Treatment of Corporate Distributions to Shareholders, 52 Columbia L. Rev. 1, 35 (1952)

Taxpayer in *Bradbury,* therefore, was thus required to pay tax on the full amount that her account was credited by the transfer back of the shares.

An even stronger statement is found in *United States* v. *Davis*, 397 U.S. 301 (1970) in which the Supreme Court held that where the sole shareholder of a corporation causes part of his shares to be redeemed by his corporation, "such a redemption is always 'essentially equivalent to a dividend' within the meaning of that phrase in Section 302(b)(1)",[9] 397 U.S. at 307. The Court further found that in such circumstances, the business purpose of a transaction is irrelevant in determining whether the redemption was equivalent to a dividend.

In sum, taxpayers here received value in the amount of $45,000 upon the redemption of their shares. The redemption did not change their ownership interests in The Moloney Corporation; they retained complete control both before and after the transaction. While there may have been a business purpose for the redemption, the net effect of the distribution was nonetheless a dividend. *Davis, supra.* Accordingly, we hold that the government properly treated the cancellation of the debt as the equivalent of a dividend in the amount of $45,000, and that therefore such amount was subject to taxation as ordinary income.

As an alternative to his holding that there had been no taxable distribution to the taxpayers, the district judge held that in any event the deficiency assessment was the product of an unauthorized additional inspection of the taxpayers' books of account which was made contrary to the provisions of Section 3631 of the Internal Revenue Code of 1939, quoted earlier. The trial judge noted that Section 3631 does not contain any sanctions for its violation. Nevertheless, the Court held:

> "The court is not inclined to render the section nugatory because it does not state explicitly that no assessment of deficiency can be made on the basis of an inspection for-

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[9] Section 302(b) of the 1954 I.R.C. is the counterpart to Section 115(g) of the 1939 Code.

> bidden by the section. Such result is implicit in the statute. Otherwise it would be completely meaningless. This same conclusion was reached by the Court of Appeals for the Seventh Circuit in Reineman v. United States, 301 F. 2d 267 (7th Cir. 1962). See also Application of Leonardo, 208 F. Supp. 124 (N.D. Cal. 1962).
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> "If, therefore, it were necessary to determine the issue of a second audit, this Court would have no alternative but to find in favor of the plaintiffs as to this question."
>
> 375 F. Supp. at 741

Although vigorously contradicted by the government, the district judge held that an unauthorized inspection of the taxpayers' books was made for the year 1952. The judge chose also to disbelieve altogether the testimony of the government agent who conducted the second audit. In deference to the trial judge's superior ability to evaluate the credibility of witnesses, we have also disregarded this testimony entirely. Thus viewed, the evidence supports a finding that the agent actually examined at least the corporate records and the partnership records for 1952.

Although the cited provisions of Section 3631 have been in effect in one form or another for many years, there has been very little judicial construction of the section and none whatever in this circuit.[10] The question is to what extent a violation of the section excuses the obligation to pay the deficiency which would otherwise exist. Since the statute itself is silent, this extreme result is warranted only if it is necessary to enforce the statutory provision. This, in turn, depends upon whether a contrary result, in the words of the district judge, would render the provision "completely meaningless".

In *Reineman, supra,* the Seventh Circuit set aside a defi-

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[10] For a discussion of the general legislative intent concerning the provisions, however, see *United States* v. *Powell,* 379 U.S. 48, 55 (1964).

ciency assessment against the taxpayer where the evidence before the district court sustained the taxpayer's claim that it was the result of a second inspection of the taxpayer's books of account, affected without written notice to the taxpayers as required by Section 7605(b) of the Internal Revenue Code of 1954 (the counterpart of § 3631). In so doing, the Seventh Circuit took particular note that the second and unauthorized examination of the books occurred without any request therefor by the taxpayers and in fact without their knowledge of its having taken place until after it was completed. Particularly because of this latter circumstance, the court in *Reineman* rejected the government's contention that the remedy for a violation of Section 7605(b) is "one of self-help – he may refuse to permit the subsequent examination and oppose the director's application for subpoena". The court observed that:

> "The short answer to this is that the taxpayers had no opportunity for self-help. Agent Rogers never made any pretense that his assignment was to reopen the year 1954 or to reaudit the books of account for that year. . . . Taxpayer was totally unaware of any re-examination, while it was in progress." 301 F. 2d at 271

The Seventh Circuit recognized those cases which held generally that re-inspection is not a bar to the assessment where the taxpayer fails to object, or voluntarily consents. See *Philip Mangone Co.* v. *United States,* Ct. Cl. 54 F. 2d 168 (1931); *Executors of Estate of Barker* v. *Commissioner,* 13 B.T.A. 562 (1928); *McDonnell* v. *Commissioner,* 6 B.T.A. 685 (1927). See also *Field Enterprises, Inc.* v. *United States,* 348 F. 2d 485, 172 Ct. Cl. 77 (1965). *Reineman* concluded, however, that

> "Under the facts of this case, taxpayers are left without any remedy to correct the illegal action taken by the Commissioner unless the deficiency assessment is set

> aside. We hold that the district court did not err in its conclusion of law to that effect."
>
> *Reineman, supra,* at p. 272

From the foregoing language, it is apparent that *Reineman* was never intended to create an automatic rule invalidating the deficiency every time there is a violation of the inspection statute. Moreover, we cannot agree with the district judge that this result must invariably follow because a contrary rule would make that section nugatory. On the contrary, while we would be reluctant indeed to hold that no circumstance may exist in which such radical remedy for violation might be appropriate, the circumstances must satisfy us that such a remedy is both justified and necessary under the circumtances as a deterrent. Whatever those circumstances may be, we do not find them here. We agree with the view of the Court of Claims that "not every infraction of the notice requirement calls for nullification of the deficiency assessment." *Field Interprises, Inc.* v. *United States, supra,* 348 F. 2d at 491.

Upon disputed evidence, we accept the taxpayers' contention that the agent did, in fact, inspect their personal records.

Since the partnership itself was not a taxable entity but merely an extension of the persons of the taxpayers themselves, partnership records were necessarily personal records and entitled to the statutory protection in the absence of a notice reopening the inspection. Cf. *United States* v. *Slutsky,* 487 F. 2d 832, 845 (2nd Cir. 1973). See also *Application of Leonardo, supra.* At the same time, the protection of the section does not extend to an examination of the corporate records, since the corporation is not the "taxpayer" involved here. *Hinchcliff* v. *Clarke,* 371 F. 2d 697 (6th Cir. 1967). It is the unauthorized invasion of the taxpayers' own books and consequently his personal privacy, which is the target of the section.

We conclude the taxpayers are entitled to the protection of the section as to their partnership as well strictly personal

records, and that the evidence supports a finding that Section 3631 was violated as to those protected records. We also conclude, however, contrary to the view of the trial judge, that the deficiency assessment was for the most part based upon information learned from the non-protected corporate records of the company. Indeed, the balance sheets, the resolution, and the tax return all relied upon by the government to establish the basis for the dividend equivalence, were not taken from either the partnership or the personal records of the taxpayers. We thus find that while the privacy of the taxpayers was invaded, this invasion was not the motivating cause of the deficiency assessment. In our view, invalidation of the assessment under thee circumstances would be inappropriate.

Further, while taxpayer here may not have given their consent to the second examination, there is no doubt that Paul Moloney unlike *Reineman, supra,* was aware of the examination at the time it took place. Indeed, the evidence in support of the finding that the examination occurred stems in large part from the testimony of Moloney that he knew it was going on while it was being conducted.

We hold, therefore, that taxpayers' proper recourse for violation of Section 3631 was, in this instance, to object to and challenge the unauthorized inspection at the time it was made. Under these circumstances, we decline to nullify what we have found to be an otherwise valid assessment of a tax deficiency.

As noted earlier, we do not pass on the question of the propriety of the partial summary judgment in favor of the government. Such a decision is rendered unnecessary by our conclusion that final judgment on the merits should be entered in favor of the government.

The judgment of the district court is reversed and the case is remanded for entry of a judgment in favor of the United States.